



Facts on Factoring: An Old Credit Alternative Has Some New Features



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Factoring is the purchase of a client's accounts receivable, or invoices, at a discount. It is not a loan. It is an unregulated business; factors charge whatever the market will bear.

In today's credit-constricted market, the factoring business is booming. Factors often use independent agents to keep sales costs low; these agents can earn a 10 percent commission on what the factor makes.

Factoring is a \$150 billion dollar industry worldwide, but it is better known in Europe than in America. In Europe it is primarily used as a source of funds for unbankable businesses.

FACTORING BASICS

Factors are more concerned about the creditworthiness of their clients' customers than that of their clients. Factoring solves cash-flow problems. Instead of waiting for payment, a company can get its invoices paid immediately. The average days' sales outstanding (DSO) is 45 days for most industries. Cash-strapped suppliers try to combat this by offering early-pay discounts to buyers, but only 1 percent of buyers take advantage of these discounts -- terms like 2 percent net 10 days or 2 percent net 15 days.

A factoring contract between the factor and the client generally spans a 12 to 18 months, in which the client agrees to factor a minimum dollar amount each month. An exception is if a client receives bank financing, which may dissolve the contract. Interestingly, most factor leads are bank referrals.

Businesses that factor do so because they can obtain cash quickly without going through a long bank loan process.

Software companies offering Web-based hosted solutions on a monthly subscription basis look for subscription factoring to advance funds to a supplier on subscription payments. This helps customer adoption by providing a cost-efficient "per-drink" business model.

MYTHS, REALITIES

Working capital lending and factoring are fraught with mythology and misconception. Here are just a few examples.

Myth: With factoring the collateral is invisible. Banks like loans secured by assets they can see and touch. It's difficult to touch an accounts receivable.

Reality: A receivable can be captured and held in an online tracking system. Any transaction a buyer or seller is involved with can be viewed and accounted for.

Myth: The perceived risk -- the troubled-business notion -- is greater than the reward. Given this, factoring requires diligence and extensive paper-based documentation. Some banks offer factoring only to their best customers if they also provide collateral.

Reality: Technology has improved to let all participants see their positions electronically. This reduces the amount of paperwork dramatically.

Myth: Factoring is an administrative nightmare, with no verification or validation of transactions. There is a great amount of due diligence to be performed.

Reality: Once again, technology comes to the rescue. Automation of the process dramatically reduces the administrative tasks involved in factoring.

When should businesses factor?

There are six reasons why companies factor their receivables:

1. Need immediate payments to improve cash flow
2. Cost of capital is more than that of factoring
3. Do not want to create more debt by adding loans to the balance sheet
4. Cannot secure bank financing
5. Cannot wait for bank financing
6. Want to build up cash reserves

A typical factoring transaction. The buyer places an order with a manufacturer. The goods are produced and shipped along with an invoice to the buyer. The buyer then sits on the invoice for as long as it can. Obviously, the longer the buyer waits to pay, the larger the DSO. To decrease

DSO, the seller turns to a factor and sells his account receivable at a discount in return for immediate cash.

In each stage of the business cycle—the supply chain—paper-work is generated as evidence of a completed part of the transaction. The receivables invoice documents the indebtedness of a buyer to a supplier. The receivable carries a definable monetary value with rights that can be transferred to a third party as commercial paper.

FRAGMENTED MARKET

No single company dominates the factoring business. Most of the larger factoring companies are focused on companies in the market's top tiers, with annual revenues in excess of \$10 million. The factoring market is divided into four categories:

1. Large factoring companies, such as GE Capital, CIT and Bibby service the large corporate market. These firms must receive a minimum commitment of \$10,000 in receivables financing per month.
2. Regional factors such as Millennium, Riviera, LSQ and Gateway may service the middle market, comprising companies with annual revenue greater than \$10 million. They, too, require a \$10,000 per month minimum.
3. Small local factors, consolidated in metropolitan areas, usually listed in the Yellow Pages under "Financing Companies."
4. Newly emerging spot factoring firms, such as Alivia Capital and the Supply Chain Finance network. These companies offer a Receivables Exchange auction site.

Factoring industry is fragmented because of lack of liquidity

Large and middle markets comprise roughly 130,000 companies in the United States. The high end and small businesses (from \$5 to \$10 million) number about 121,000. Small businesses (\$1 million to \$5 million), micro businesses (\$50,000 to \$1 million), and SOHO/self-employed, with various revenues, round out the rest of the tiers.

NEW FACE OF FACTORING

Perhaps the most significant change in factoring is the creation of spot factoring—the factoring of single invoices. Unlike generic factoring, spot factoring does not require a minimum dollar amount or length of time. Spot factoring gives the seller of the receivable enormous flexibility, freeing the seller of commitments of six months or more of factoring all receivables, even if the need for support lessens or goes away.

Spot factoring is Web-based and electronic rather than paper-based. Its transactions take place on auction sites, with lower rates, smaller reserves, no long-term contracts and no recourse. Spot factoring is done one invoice at a time—basically a "credit-card model"—and is perceived as carrying lower risk than traditional factoring over an extended period.

Another dramatic development is online factoring. This method generally has lower rates than traditional factoring, with no minimums. The A/R seller receives 100 percent cash up-front. It is easy to sign up for this process; there is no nonpayment insurance required; and it allows for small invoice amounts. Two online factoring companies are INZAP Factoring and Facticeon.

A variation on online factoring is the emergence of auction Web sites where suppliers sell invoices to the highest bidder. There is generally a limited time frame for the bidding and the results of the winning bid are available once the bidding has concluded. Two examples of this type of auction sites are Receivables Exchange and DebtX.

The final variation is the bank hybrid model that combines many of the benefits of the previous models. The bank maintains the customer relationships and has the ability to evaluate the creditworthiness of companies. This reduces the risk borne by the factor and gives the client the best value for its receivables.

The bank hybrid method also is online and gives both sides of the transaction complete visibility into all details of the transactions. Finally, the bank hybrid model allows each participant to plug into a network of payment solutions and financing companies. Alivia Capital, for example, offers this type of factoring.

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